Testimony of the
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to the
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of the
U.S. House Financial Services Committee
on
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Modernization of State Insurance Market Conduct Examinations

The Alliance of American Insurers is a national trade association representing over 340 property-casualty insurance companies doing business nationwide. The Alliance has been actively involved in the market conduct issue since the 1979 McKinzie study recommended that states conduct market conduct exams. In general, the Alliance has supported efforts by the NAIC and the states to improve the examination process, and has supported well-trained and experienced insurance department staff as examiners. The Alliance has also historically been concerned about the costs of market conduct exams and has sought efficiency in the process. The Alliance believes that there are reasonable and practicable steps that all states can take to improve their market conduct regulation. We appreciate the opportunity to present testimony.

The Alliance Perspective on Market Conduct Examinations

On-site market conduct exams are one of the many methods by which state insurance regulators oversee and verify the compliance of insurers with state laws and regulations. Exams are not the only point of contact that insurance regulators have with the entities they regulate. Among many other contacts, state regulators license companies and agents; they have authority to approve the rates and forms that insurers use; all states handle an enormous volume of consumer complaints every year; they receive reports on holding company transactions and must approve significant transactions; and they address

developing market conduct problems with regulations under their unfair trade practices and unfair claims settlement practices laws. State insurance regulators also have a wide variety of effective administrative options short of an on-site examination to address potential market conduct problems with insurers ranging from simple informal inquiries to submission of interrogatories to performance of desk audits. The on-site market conduct examination system must be seen in its context of one tool in state regulators' kit. The fact that an insurer has not been examined recently by no means indicates its market behavior has gone unregulated.

In terms of the efficiency and effectiveness of the current state market conduct examination system, Alliance members have several overriding concerns with the market conduct process.

- **Focus on General Business Practices** – One such problem is that examiners focus on documenting and verifying an insurer's compliance with applicable laws and regulations, rather than on its general business practices. For example, an insurer with a very low number of complaints and a very low error ratio upon a sampling of its underwriting or claims files can still be subject to insurance department penalties for failing to exactly document its compliance or for other minor technical or clerical errors.

- **Coordination and Consistency** – Our members also find that there is a lack of coordination among the states regarding scheduling exams and a lack of consistency among the procedures and requests of each state. Some large companies feel that they are examined more frequently, not because they have more problems, but because they represent a large percentage of the market share that the state insurance department needs to examine. A large company can have numerous different state insurance department examinations being conducted at the same time, with each state making different demands for information in different formats. Market conduct exams use an increasing amount of company resources in terms of office space, staff time, and systems time, among other resources.

- **Targeted Exams** – Too many market conduct examinations are still broad and unfocused. The Alliance and the industry in general has constantly urged that states conduct "targeted" examinations, rather than periodic and comprehensive examinations. Many states contend that their examinations are "targeted" when they are actually focused very broadly on "claims" or "underwriting," rather than on specific issues or problems, such as private passenger auto collision claims in 2000 involving the use of aftermarket parts. Exams still need to be more carefully targeted by issue and by company.

- **Fines and Penalties** – A most significant concern is the fines that result from market conduct exams. If the stated purpose of market conduct exams is to improve a company's compliance with state laws and regulations, then the result

of an examination should be focused on correcting problems. Insurers should be given an opportunity to correct problems before they are fined.

- **Subjective Factors** – State market conduct examiners often interpret the laws and regulations during the course of an examination. Many times, an examination is the first time an insurance company is informed of insurance department expectations for compliance with a particular law or regulation. As a result, the company has violated the law and is subject to fines.

- **Costs of Exams** – Alliance members have also expressed concern about the cost of market conduct exams in general, and on the increasing use of contract examiners, who substantially increase the cost of examinations. Sometimes an insurer can get a glowing report but the cost is a lengthy exam. Contract examiners tend to exacerbate this problem. Such examiners may not be familiar with the specific state laws and practices, have the incentive to find errors and violations, and will often interpret the statute themselves.

Creating a More Rational Basis for Identifying Problems and Triggering Action

Alliance members often question what triggers a market conduct exam. Some companies feel that states continually examine the large companies in order to report that they have examined a significant portion of the market share in the state. Some Alliance members report that even when market conduct examiners have particular issues on which they are focusing, they tend to examine all or as many companies as possible for that issue, rather than choose specific companies based on potential problems. There are also isolated instances among the Alliance membership of a market conduct examination being initiated for a punitive purpose based on the fact that the insurance department did not like the way the company handled a particular claim or some other legitimate action that the company undertook.

The Alliance believes that there is reliable and useful information about insurers available to all states that would provide a more objective and rational basis for identifying market conduct problems and triggering insurance companies for action. The Alliance believes that the following should be adequate and accurate market conduct triggers that all states could use:

- **Complaint Data** – An effective market conduct process should begin with consumer complaints and inquiries as a compass for state insurance regulators. In the early 1970s, the McKinzie Report on financial and market conduct examinations recommended that market conduct exams should be driven by consumer complaints, and in 1979, the General Accounting Office advocated this same policy. It remains good public policy today. With the consumer in mind, what better way to use limited state insurance department and company resources than to examine companies for the problems that consumers consider most important to them, namely, those for which they have filed a grievance with the state insurance department.

To use complaint information accurately, states will have to put complaints into their proper context. Sheer numbers may be misleading. States will need to look at justified vs. unjustified complaints, and otherwise compare a company's complaints to its policies, premium volume, mix of business and the size of the risks it writes, among other factors. The bottom line, however, is that complaint data should be a primary market conduct indicator that all states can and should use in market conduct regulation.

- **Statutory Page 14 Changes** – Every insurance company files a Statutory Page 14 with each state giving the details of its business in the state. This includes a variety of factors and ratios that should be of key interest to the states in market conduct surveillance. The Alliance believes that key market conduct indicators should be significant changes in the Page 14 ratios, such as changes in the company's overall market share in the state or in specific lines; changes in the loss and expense ratios; and changes in defense costs, among others. A rapid change in any of these indicators by itself does not indicate that a company has a problem, but should signal the regulator that more information should be sought as to the reasons for the changes in the Page 14 data.

- **Changes in Management** – Significant changes in the company's management, through changes in officers and directors or through mergers and acquisitions and other business affiliations may signal changes in company's operations. Again, this does not necessarily indicate market conduct problems. In fact, such changes could be a significant improvement for services and financial stability to the policyholders. Management changes reported on the Annual Statement or in the insurer's holding company registration statements should, however, be one indicator that insurance departments use to seek additional information to detect potential market conduct problems. Management competency is an increasingly important market conduct indicator.

- **Other Significant Company Changes –** Through published reports, the trade press or other sources, regulators are advised of other significant changes in a company, such as a major systems update or consolidation of offices, which may generate errors. Any such major change in a company's operations or facilities could be a market conduct indicator.

These are indicators that are applicable to all lines and all company activities. All states currently receive the above information on a regular basis so it would be a method of market conduct analysis that all states could use right now to provide a more systematic basis for targeting insurers for examination. This type of analysis can also be done within state budget constraints.

Illinois and Ohio use an annual market statement approach. The Illinois Market Conduct Annual Statement covers auto and homeowners and it collects information on claims activity, such as the number of claims open and claims closed, the date of report to date

of final payment, the date of accident to date of report, and number of claims in litigation. Illinois also collects the number of agents by zip code. The Ohio Market Conduct Annual Statement is similar to Illinois in that it asks for claims activity and the date of report to the date of final payment. Ohio also asks for claims complaint information. These annual statements are targeted at personal lines, which are of most importance in terms of consumer protection. Alliance members generally report that these states genuinely do use this information to target companies for exams, and that they can produce the data requested, at least after the companies have gained experience after a year or two of collecting and processing the requested information.

If more states were to use a market conduct annual statement, however, consistency is critical in both the data requested and the state usage to trigger further market conduct review. Otherwise, 50 different demands for data would be much more burdensome and costly, particularly when compared to the market conduct indicators listed above that states could easily generate from information already available.

Better data and more sophisticated analysis is always possible, but it always involves additional costs, which are ultimately borne by the insurance consumers. The Alliance believes that the above market conduct indicators are not only reliable, but that they are readily available to all states at no additional cost to regulators or the industry. States should start with these common indicators that they all now have before any other new data source is developed or required. It may be particularly useful to the new NAIC Market Conduct Analysis Working Group to have all states readily able to use the same market conduct triggers right from the start of its work.

Determining an Appropriate Response to Market Conduct Problems

Once the market conduct indicators suggest a potential market problem, the Alliance believes that states should have a menu of possible responses, with an on-site market conduct examination being a last resort. For example, if a company's market share is rapidly increasing, the insurance department should contact the insurer and ask for information regarding its number of licensed sales representatives agents and brokers and its number of licensed adjusters to see if there are proportionate increases in those areas. Similarly, increasing loss and expense ratios should trigger a request for the number of rate and form filings being made, whether informational or not.

States have implemented such market conduct procedures short of an on-site exam. North Carolina, for example, has an interrogatory process that most Alliance members find to be very effective and efficient. Rather than conducting an on-site examination, the North Carolina departments calls or has an informal meeting with a company to discuss potential problems, and sometimes sends interrogatories to the company regarding that problem or to the industry in general regarding the compliance on a particular issue.

States also have found ways to assist insurers with their compliance. Some states routinely publish, on their websites or by way of department bulletins, their priorities for market conduct analysis or market conduct exams. Some states publish a list of the most

common or the most serious violations they have found in recent exams. Insurers are willing to learn from others' mistakes and receipt of this kind of information from state insurance departments promotes compliance.

Some departments have issued interpretative guidelines on various laws and regulations. Sometimes this is done after surveying the industry for compliance benchmarks, and other times it is after one or more market conduct examinations when it is apparent that insurance department expectations and insurance company interpretation under state laws are different. Occasionally, insurance departments issue bulletins to publish department opinion or expectations with little input from or industry experience with the matters in question. States that issue such interpretive guidance need to understand that these are not the equivalent of statutes or formal regulations and that such bulletins are not binding on the industry.

The Alliance believes that companies should not be examined until there is a reasonable cause to believe that a violation or specific problems exist within the company. This is particularly true for companies with a small premium volume in the state. To trigger a costly on-site exam when there are no red flags about the company's writing is not the best use of limited resources. There are many other beneficial steps that that states could take, short of an on-site exam, to address market conduct and compliance problems. Many of these steps have already been suggested by the NAIC Market Conduct Working Group in the outline for its paper to improve the state system:

- *Informal inquiry (phone or letter) to confirm identification of department concerns;*

- *Interview or other Informal Review – meeting or call between regulators and insurer to see if the matter can be sufficiently explained and resolved;*

- *Interrogatories to the company for more information;*

- *Interrogatories to the industry, if appropriate, to determine benchmarks for compliance, particularly if a new law is involved;*

- *Industry/Company education—interpretative department bulletins, seminars;*

- *Policies and procedures reviews;*

- *Desk Audits;*

- *Data Calls—Company/Industry;*

- *Targeted Exams (e.g. private passenger auto claims in 2000 involving the use of aftermarket parts);*

- *Investigations;*

– *Comprehensive Exams.*

Developing More Consistency in Market Conduct Examination Procedures

The NAIC has long had a Model Market Conduct Examination Handbook that many states follow. This does not necessarily mean, however, that there is exact uniformity among the states conducting exams according to the procedures in the Handbook. While the Handbook instructs states in the steps in conducting the exam, such as notice of an exam, use of sampling techniques and preparation of an examination report, each state goes about those steps differently. The NAIC Uniformity Working Group has been developing uniform examination procedures for use among the states, and the uniformity document that has been developed is similar to a list of "best practices" for the states.

The Alliance believes that all states should implement most of the recommendations of the NAIC Uniformity Working Group report, but recognizes that not all of this can be done at the same time and all at once. Therefore, the following would be priorities for the Alliance in implementation:

- **Develop a Standardized Data Call** – A standardized list of the data items that states may want to review in an exam would save a significant amount of time and costs. Even if every market conduct examiner only wanted a subset of the whole standardized data call, having a standard template would make the information easier to produce for each exam. For example, if it is determined that there are 45 items that examiners could potentially want to see on a policy edit, an insurer could devise a program that captures all 45, and when a state comes in and only wants to see 10 or 20 of them, insurers would not have to go back and devise a new program each time. They'd just select these 10 or 20 items from their existing program. Such a process would make the information easier and faster to produce for each market conduct exam. The NAIC has developed a standardized data call. Now the modernization will occur when all states conducting market conduct exams use it exclusively.

- **Exam Planning** – As much information as possible about the exam and sufficient lead time is significantly beneficial to Alliance member companies. States that clearly state the parameters of an exam and otherwise plan in advance for it, and communicate that to the company, greatly help both parties in the equation. The company can have the information that market conduct examiners want ready and available when they arrive. It is very important for the states to give companies the projected time frames of the examination advance in order for them to plan for systems and staff time. A projected budget for the exam should also be provided, particularly when a contract examiner will be used.

  Planning helps the regulator as well. Some Alliance members report state insurance department examiners having to wait idly while another state finishes an exam before they can start their own exam. Examiners requesting data and

other information for the first time when they are on-site may have to wait for the company to produce it, thus delaying their examination.

The NAIC has developed a Pre-Exam Planning Checklist for this purpose. It is an excellent statement of best practices for the states in planning for an exam. Modernization of the state process will now occur when all states conducting exams implement it.

Many of the recommended practices and processes in the NAIC Uniformity Working Group report mirror what the Alliance and the other trade associations have previously suggested in their 12-point program. A copy of that joint trade statement is attached.

Promoting Compliance and Corrective Action in Enforcement

Fines should not automatically be a result of a market conduct exam. Rather, the focus should be on corrective action and bringing insurers into compliance with the law. The Alliance suggests a graduated response once a company has been examined:

- *Market Conduct Exam;*
- *Procedure to Discuss Findings and Conclusions with the Insurer;*
- *Exam Report;*
- *Issuance of Cease and Desist Order or Order to Come into Compliance With Specified Time Frames;*
- *Later Request of Company to Demonstrate Compliance or Later on-Site Verification of Compliance;*
- *Fines/Penalties for Non-Compliance.*

When ordering corrective action after an exam, some insurance departments impose records keeping requirements, generally intended to assure that the company comes into compliance and better documents its actions. The sum total of multiple states each creating specific procedures and record retention requirements for an insurer can be burdensome. The Alliance believes that insurers need the flexibility to correct problems in a way that it is consistent with company practices and internal systems rather than trying to impose a specific method on the insurer. If a violation has been found and corrective action is needed, the company examined has every incentive to make the necessary changes. All the company usually wants to do is find the most cost efficient way of making the adjustments.

Another issue that arises in connection with determining the appropriate response is how to treat multiple instances of a single error. Some states recognize that a single error can be repeated multiple times if that error becomes incorporated into a company system or

procedure. Many states recognize this as a single error or glitch while other states count it as multiple violations. For purposes of a market conduct report and corrective action, these should be counted as single error.

If fines are a result of an exam, what is the proper basis for fines? Generally speaking, departments seem to have two types fines. One type relates to the specific actions of the insurer examined and the nature of the violation. The amount would vary by company. The other type seems to be an automatic fine for certain types of violations, such as failure to submit timely holding company statements, and the fine is the same for every insurer. In the former case, which is more common, Alliance members often do not understand the basis for the fine nor the manner in which the department arrived at the actual dollar amount. The Alliance suggests that state insurance departments implement the following guidelines in imposing fines:

1. *States should have the authority to impose fines if an insurer knowingly and intentionally violated the law/regulations;*

2. *A fine should not automatically result from a market conduct exam. Rather, states should give first notice, require corrective action and permit time for remedial action to take place. If corrective action is not taken, a fine is appropriate. For example, If there is no intentional violation and an insurer acted in a manner reasonably believed to be in compliance with the law, no fine should be forthcoming if the company agrees to take remedial action in the spirit of compliance.*

3. *No fines should be imposed unless the insurance department has previously issued guidance, interpretation or its expectations regarding compliance with the law when the violation revolves around a department interpretation of the statute. Rather, in this case, the insurer should be able to contest the interpretation through the administrative process without penalty or the department should issue a corrective order to the insurer.*

4. *Any fine should reflect the actual harm done to the public; e.g. was the policyholder/claimant hurt by the insurer's conduct?*

5. *State regulators need flexibility in the process to consider mitigating factors when imposing a fine;*

6. *Adequate administrative procedures need to be in place to permit review of fines and penalties.*

A few states have adopted laws or regulations setting forth specific dollar fines for listed violations. The state insurance department is given no authority to consider mitigating circumstances. It makes no difference, for example, if the violation was knowing and intentional or a result of a glitch in a new computer system. Such a law also makes the exam process more contentious as the insurer must dispute the finding of a violation as a fine will be automatic if the violation stands. Dollar amounts set forth in a statute also

require continuing legislative change to update them. The Alliance takes no position on the dollar amount of fines and recognizes that the amounts put into a statute will vary by state. If states are inclined to specify dollar amounts for fines, the insurance department still needs to be given authority to consider mitigating circumstances and corrective action should still come before any fine is imposed.

What Needs to Be Done to Modernize the Current State Market Conduct Examination System?

The Alliance believes that there are steps that all states can take to improve market conduct regulation. The Alliance envisions a market conduct process from start to finish that is as follows:

- Targeting companies and specific problems from use of the following indicators:
    - *Consumer complaint data;*
    - *Changes in Page 14 Ratio;*
    - *Changes in company management;*
    - *Other major company changes.*
- Informal inquiry (phone or letter) to confirm identification of department concerns;
- Interview or other Informal Review – meeting or call between regulators and insurer to see if the matter can be sufficiently explained and resolved;
- Interrogatories to the company for more information;
- Interrogatories to the industry, if appropriate, to determine benchmarks for compliance, particularly if a new law is involved;
- Industry/Company education – interpretative department bulletins, seminars;
- Policies and procedures reviews;
- Desk Audits;
- Data Calls – Company/Industry;
- Targeted Exams;
- Investigations;

- Comprehensive Exams;
- Procedure to Discuss Findings and Conclusions with the Insurer;
- Exam Report;
- Issuance of Cease and Desist Order or Order to Come into Compliance With Specified Time Frames;
- Later Request of Company to Demonstrate Compliance or Later on-Site Verification of Compliance;
- Fines/Penalties for Non-Compliance.

The Alliance believes that regardless of a state's current situation regarding market conduct analysis and examinations, there are steps in this suggested continuum that each state can take to improve its process.

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STATEMENT OF THE ALLIANCE of AMERICAN INSURERS AMERICAN INSURANCE ASSOCIATION NATIONAL ADSOCIATION of INDEPENDENT INSURERS NATIONAL ASSOCIATION of MUTUAL INSURANCE COMPANIES

12 POINT PROGRAM
TO IMPROVE MARKET CONDUCT EXAMINATION PROCESSES

The Alliance of American Insurers, American Insurance Association, National Association of Independent Insurers and National Association of Mutual Insurance Companies commend the NAIC Market Conduct Issues Working Group for examining ways to improve market conduct examination procedures. This is important work, which the members of all four trade association endorse.

The trade association have discussed with their respective members suggestions and recommendations for improving market conduct examination procedures. As a result of those discussions, the four trade associations have developed a 12 point program for improving these procedures. For the most part this program does not require development or adoption of new model laws or regulations and the 50 state legislative effort such a program would require. It does not require creation of interstate compacts or other regulatory mechanisms that would require either congressional or state legislative activity. Instead, this 12 point program promotes measures which state Insurance Departments may undertake under current statutory authority and therefore could be implemented immediately. The members of all four trade associations believe that implementation of these proposals will make market conduct examination procedures more efficient without jeopardizing any protections afforded by market conduct examinations to the consumer.

The specific 12 points advocated by the four property and casualty trade associations are as follows:

1. The overriding goal of market conduct examination should remain as stated in the Market Conduct Examiners Handbook, which states, “the market conduct examination can be most effective if it focuses on general business patterns of practices of an examinee. While not ignoring random errors, the market conduct examination should concentrate on an insurer’s general practices.” Examinations that focus on single inadvertent errors do little to further consumer protection and do not maximize the use of market conduct resources of the Insurance Departments.

2. States should strive for greater coordination among the states as concerns scheduling and conducting market conduct examinations of insurers. States should be encouraged and should more fully utilize the Examination Tracking System at the NAIC. Members of all four trade association oppose applying the multistate examination concept to property and casualty insurers. There are simply too many variations in the market conduct standards from state to state in the property and casualty area to make the multistate examination process feasible at this time.

3. Departments should rely more fully on targeted market conduct examinations rather than comprehensive examinations. Departments would be better served directing resources to “problem” companies in the market conduct examination area. Complaint volume, sudden changes in complaint volume and utilization of desk audit tools could be used by Departments in identifying “problem” companies.

4. The NAIC should develop and the Departments should follow uniform standards on examination notices, including sufficient advance notice and notice regarding change in scope of the examination.

5. Departments need to exercise greater oversight and control of examination costs. Tools that should be utilized in this area include (a) sharing and discussing with the insurer prior to the market conduct examination the Department's time budget and work plan for the examination; (b) sharing budget projections with the insurer and developing compensation standards when the Department utilizes contract examiners; and (c) developing a peer review system or other appeals process for review of examination billings when there is a dispute between the insurance company and the Department over a billing.

6. All states must adopt and adhere to the procedures and guidelines set forth in the Market Conduct Examiners Handbook.

7. The NAIC should develop and the Departments should follow uniform standards for requesting data from insurance companies during market conduct examinations and for the collection of this data.

8. Final examination report changes are needed. First, the NAIC should develop and states should follow a uniform standard for when such final examination reports must be completed. Second, insurance companies should be given the opportunity to include within the final examination report a discussion of any disagreements that the company has with the findings and the company's reasons for those disagreements. This will allow subsequent examiners within the same department or examiners in other states that will review the final examination report to be aware of and have an opportunity to consider the insurer's disagreements and reasons for the disagreements.

9. There must be a rational basis for assessing administrative penalties and establishing the size of those penalties. The penalty structure should also allow the insurance company to take remedial action to correct any violations uncovered in a market conduct examination. If such action is taken within a reasonable time, administrative penalties should be waived or reduced. This penalty structure is consistent with the overall objective of market conduct examinations, which is to identify and eliminate insurance company practices in violation of the insurance code and regulations.

10. The NAIC and states should continue to adopt minimum training standards for market conduct examiners. This may include requiring designations under the Accredited Insurance Examiner or Certified Insurance Examiner programs for specified market conduct examiners. Minimum training standards involving technology or the use of automated market conduct techniques should also be developed and required of examiners. Training programs on the Market Conduct Examiners Handbook and the proper purpose of market conduct examinations should be developed and encouraged. Both the regulatory and insurance communities must fully support the efforts of the Insurance Regulatory Examiners Society.

11. Insurance companies must be given sufficient time in which to come into compliance with new or amended statutes and regulations that require changes in company operation, Too often the statutes or regulations require compliance within an unreasonably short timeframe, particularly when they require system changes for insurance companies. The

NAIC should encourage and state insurance departments should work with the industry in promoting this objective in all legislation and regulation impacting company operations.

12. The NAIC should adopt the National Conference of Insurance Legislator's Insurance Compliance Self-Evaluative Privilege Model Act as an NAIC model.

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